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Policy Lending for LGUs: An Innovative Financing Instrument for Local Governments

*Gilberto M. Llanto**

The passage of the landmark Local Government Code of 1991 ushered in a new era in local government credit financing, what with the inclusion of a provision that allows local government units (LGUs) to borrow from private and government financial institutions without prior approval by the Department of Finance.[1]

What has constituted as a major source of loan financing for local governments since the Code's passage is the Municipal Development Fund (MDF). Created by Presidential Decree 1914, the MDF serves as a revolving fund for official development assistance (ODA)-supported projects of local governments.[2] Through programs like the Municipal Development Program, Community-Based Resource Management Program, and Local Government Finance and Development Program, the MDF provides loans to finance revenue generating, social infrastructure and environmental projects of local governments.

The loan repayments made by the local governments have, through the years, accumulated into a "second generation fund," the amount of which has become substantial that could be used for various purposes.

What to do with the fund: pushing for innovation or doing a quick fix?

The good news is that the second generation fund has not remained idle. In fact, recently, the Policy Governing Board of the Municipal Development Fund Office (PGB-MDFO) has decided to use it for program or policy loans to local governments. The intention is noble: to influence local governments to adopt policy and institutional reforms needed at the

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*The author is Vice-President of the Philippine Institute for Development Studies (PIDS) and Research Fellow at the Rural Development Research Consortium, University of California, Berkeley. He was formerly Deputy Director-General of the National Economic and Development Authority (NEDA).

[1]From the Foreword of then PIDS President Dr. Ponciano Intal, Jr. for the book entitled *LGU's access to private capital markets*, 1998.

[2]On November 20, 1998, Executive Order No. 41 created the Municipal Development Fund Office (MDFO) as a separate office under the Department of Finance (DOF) to manage the Municipal Development Fund (MDF). Until then, the MDF was with the Bureau of Local Government Finance of the DOF.

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Ms. Jennifer P.T. Liguton helped in recasting this *Notes*. The views expressed are those of the author and do not necessarily reflect those of PIDS or any of the study's sponsors.

subnational levels of government with the use of such loan.[3] The PGB-MDFO believes that with greater flexibility in the use of the policy loan, local governments can be so motivated to adopt policy and institutional reforms needed at the local level. This is an innovative way to influence policy reforms at the local government level since it is not as limiting as the current project-based lending where the project objectives and scope are more focused and time-bound, e.g., provision of level II water to identified target beneficiaries. To enlist the use of the second generation fund of the MDF for policy lending is therefore a welcome move.

Unfortunately, however, the bad news is that there is also a view among certain quarters that said accumulated funds should be remitted to the national treasury to meet some very short-term objectives such as the shoring of the fiscal deficit.

Because the second generation fund is a very liquid fund, there is a suggestion to use it partly to cover the country's large fiscal deficit. Indeed, the fiscal situation is precarious but this particular course of action is no more than a quick fix whose beneficial impact may be short-lived, albeit quite immediate.

Moreover, the enduring solution to the fiscal deficit is not the quick fix type. It is the traditional, classic solution of promoting greater revenue effort from tax revenues and a more efficient management of public expenditures.

Granting, therefore, that the argument against the use of the second generation fund for a quick fix solution to the country's fiscal deficit problem is accepted, then one may consider two other innovative uses of the fund apart from that of a program or policy loan.

One is its possible use as a leverage to draw more funding for local projects without need perhaps for more foreign loans. The availability of such funding for local or countryside development will help the national goal of poverty reduction. And the other is its use to strengthen the capital base of an independent, self-sustaining corporate-type MDFO that could evolve from the current MDFO that is completely dependent on national government budgetary allocation.

What is a "local program or policy loan?"[4]

The PGB-MDFO defines a "local program or policy loan" as "funds which are lent out for the purpose of assisting the local governments to attain or achieve certain policy targets or reform objectives." This is a very different type of financial instrument for local governments. It may be used for budgetary support or for the implementation of an activity, e.g., reform in local procurement, the end result of which is improved local fiscal performance or other reforms at the local level.

Key reform areas include the following: fiscal administration, revenue collection, local budgeting, expenditure management and overall governance. The approach is to have an agreement between the MDF and a local government over the implementation of certain policy or institutional reforms for a certain period of time in exchange for a policy loan. Box 1, for example, shows the proposal of the Province of Negros Occidental for a policy loan of P120 million to fund its Procurement Policy Program.[5]

The challenge and incentives to reform

Assuming that policy or program lending for LGUs becomes a regular financing instrument for local governments, what guidelines, terms and conditions are to be set up in order to determine the usefulness and feasibility of the reforms to be proposed for the use of the loans?

The challenge to local policymakers and the PGB-MDFO therefore is how to determine the set of policy or institutional reforms that would be pursued by the LGU in fulfillment of the conditionalities required by the program or policy loan and to establish the terms and conditions that would motivate the expected change in behavior of the local government.

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[3]Program lending to local governments mimic the instrument used by multilateral donors not only to fund public expenditure programs but also to introduce policy reforms in a borrowing country.

[4]This draws on the MDF concept paper on program lending for local government units.

[5]The PGB-MDFO approved the proposed program loan on 27 March 2003. The terms and conditions of the approved program loan may vary from the presentation in Box 1.

Box 1. Proposed program loan for Negros Occidental

Negros Occidental is a first class province with a population of 2.6 million. The total land area is 7,926 kilometers. As of June 2002, total income is P936.7 million, of which P782.2 million represents internal revenue allotment and P55.8 million, local income.

The province is composed of 19 municipalities: Cauayan, EB Magallona, Hinigaran, Ilog, Isabela, Moises Padilla, San Enrique, Toboso, Binalbagan, Calatrava, Candoni, Hinoba-an, La Castellana, Manapla, Murcia, Pontevedra, Pulupandan, Salvador Benedicto and Valladolid; 12 component cities: Kabankalan, Escalante, Himamaylan, La Carlota, Sagay, San Carlos, Sipalay, Talisay, Bago, Cadiz, Silay and Victorias; and one highly urbanized city: Bacolod.

The reform would focus on e-procurement, a key aspect of the Government Procurement Reform Act (January 6, 2003) at the level of the province as well as its municipalities and cities.

The policy objectives of the procurement program of the province are:

- To foster transparency and good governance
- To upgrade the financial planning and management both at the provincial and municipal levels
- To improve the cash flow position of the province and all participating municipalities and cities
- To streamline the procurement processes and encourage competitiveness by extending equal opportunity to enable eligible and qualified private contracting parties to participate in public biddings.

The plan is to complete the Procurement Policy Program of the province within 18 months from the signing of the Memorandum of Agreement with the Department of Budget and Management Procurement Service. The expectation is to have at least eight cities and 12 municipalities as well as the provincial government itself implementing the procurement reform, including e-procurement.

Terms and conditions:

- Interest rate : nine percent (9%) per annum, fixed
- Maturity : 10 years inclusive of two years grace on principal payments
- Mode of payment : semi-annual
- Disbursement : four tranches as agreed upon between the MDFO and the province based on compliance to identified deliverables/conditions.

Source: Policy lending for local government units presentation by MDFO, 2003.

This is thus a cost-benefit exercise for the local government. The local government should be convinced of the benefits of achieving the set of policy or institutional reforms relative to the pain of fulfilling the conditionalities and the cost and terms of the loan.

The prize of a successful achievement of the intended policy reforms could be, among others, the attraction of more investors to establish businesses in the local government's jurisdiction, a good chance at the polls for elective officials during election time, and heightened self-esteem of the local government. Juxtaposed against the cost of fulfilling certain conditionalities as well as the terms of the loan, the benefits should carry a greater weight in the local political calculus.

Eligibility criteria

How may a local government therefore avail of such program or policy loan?

The PGB-MDFO has established the following as criteria for eligibility to the loan.There are, however, observations on these criteria which this author indicates below:

It is important to have a more responsive, autonomous and financially independent organizational structure for the MDFO that will lead to more innovations and better outreach to local governments, especially the lower income local governments.

- **The borrowing local government unit must be a province**. The PGB reasons that "the province is mandated to oversee the municipalities and cities under its legal jurisdiction and is consequently the entity most appropriate to facilitate the policy reform program for the entire LGU."

  This is not self-evident. There are also significant policy and institutional reforms either at the cities or municipalities. However, for a start, it may be all right to test the efficacy of local program loans with provinces.

- **The province must already have a policy reform program currently in place and being implemented**. According to the PGB, "this is to ensure that the policy reform does not start at a zero base and reflects the commitment of the province to pursue the policy reform."

  It may indeed be strategic and advantageous to first start a new program with those who have made the initial investment or move toward improving their respective fiscal administration.

- **The province must be committed and willing to pursue the policy reforms in a majority, if not all, of its municipalities and component cities**. The province takes responsibility, therefore, "for the implementation of the policy reforms at the level of its respective LGUs that is crucial to whether the province is ready to undertake a policy reform program loan."

  This is a difficult task for the province. In a principal-agent framework, the crucial issue is monitoring the agent's effort and ensuring that the right incentives are in place to motivate the expected results. What is in it for the province? What is in it for the municipalities and the component cities? What do the economic and political calculus yield? Would the program loan package, that is, the size of the loan, the flexible use of the loan, the timeliness of the loan in achieving the policy agenda set by the local chief executive, the loan terms and conditions and the opportunity cost incurred on the misuse of the loan proceeds, be an effective inducement to reach the policy goals?

Concluding remarks

The innovative loan product developed by the MDFO for improving local fiscal performance is an important development in local government credit markets. And while it is too early to assess its impact on local government credit financing, a sure source of local financing would certainly be welcome to local governments that could be enthused to adopt policy and institutional reforms.

At the same time, a larger issue concerns the future organizational structure of the MDFO. Definitely, past experience points to the great constraint imposed on it by uncertainties surrounding budget programming, allocation and funding as well as its limited outreach, among others. It is thus important to have a more responsive, autonomous and financially independent organizational structure for the MDFO that will lead to more innovations and better outreach to local governments, especially the lower income local governments.

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For further information, please contact

The Research Information Staff
Philippine Institute for Development Studies
NEDA sa Makati Building, 106 Amorsolo Street
Legaspi Village, 1229 Makati City
Telephone Nos: 892-4059 and 893-5705
Fax Nos: 893-9589 and 816-1091
E-mail: gllanto@pidsnet.pids.gov.ph; jliguton@pidsnet.pids.gov.ph

The *Policy Notes* series is available online at http://www.pids.gov.ph